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Edward Yorio

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# THE TAXATION OF DAMAGES: TAX AND NON-TAX POLICY CONSIDERATIONS

Edward Yorio†

In 1955 the Supreme Court handed down a landmark decision, *Commissioner v. Glenshaw Glass Co.*,<sup>1</sup> in which it held that punitive damages and other windfall recoveries were includable in gross income under the federal income tax.<sup>2</sup> Although the rules for taxation of damages were reasonably clear prior to this decision,<sup>3</sup> *Glenshaw Glass* resolved the few unsettled areas.<sup>4</sup> Since then the law has changed little<sup>5</sup> and the prevailing rules can be summarized briefly:

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† Associate Professor of Law, Fordham University School of Law. A.B. 1968, Columbia University; J.D. 1971, Harvard Law School.

<sup>1</sup> 348 U.S. 426 (1955).

<sup>2</sup> Although *Glenshaw Glass* clarified many damage taxation issues (see note 4 *infra*), its constitutional basis remains uncertain. The opinion can be interpreted to stand for two different propositions. On the one hand, the Court may have been broadening the meaning of "income" under the sixteenth amendment to include punitive damages. Alternatively, the Court may have been holding that an income tax on punitive damages is not a "direct" tax, and is, therefore, constitutional, even if punitive damages are not "income" within the meaning of the sixteenth amendment. For an excellent analysis of this constitutional question, see Wright, *The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts*, 8 STAN. L. REV. 164 (1956).

<sup>3</sup> Shortly after the enactment of the 1913 income tax, Henry Campbell Black accurately prophesied the fundamental rules that later developed for taxing damage awards:

If the cause of action were an injury to property or contract rights, [the judgment] might be considered as, in some sense at least, a replacement of capital. If it were for services rendered, the amount of the judgment would clearly be "compensation," or even "salary" or "fees," though recovered by suit. But a judgment in an action of tort, as, for example, defamation of character or negligence causing personal injuries, would never be regarded as a part of one's income in the common acceptance of the term.

H. BLACK, A TREATISE ON THE LAW OF INCOME TAXATION UNDER FEDERAL AND STATE LAWS § 38, at 90 (1913).

For a comprehensive summary of the pre-*Glenshaw Glass* state of the law, see Plumb, *Income Tax on Gains and Losses in Litigation* (pt. 1), 25 CORNELL L.Q. 221 (1940).

<sup>4</sup> The taxation of punitive damages and other windfall recoveries was disputed at the time of *Glenshaw Glass*. Compare *Central R.R. v. Commissioner*, 79 F.2d 697 (3d Cir. 1935) (windfalls not taxable) and *Telefilm, Inc.*, 21 T.C. 688 (1954) (punitive damages not taxable), *rev'd*, 5 A.F.T.R.2d 1804 (9th Cir. 1955) with *Park & Tilford Distillers Corp. v. United States*, 107 F. Supp. 941 (Ct. Cl. 1952) (recovery of insiders' profits taxable). One commentator has stated that before *Glenshaw Glass* a taxpayer had at least a 50-50 chance of excluding treble damages in an antitrust recovery. Wright, *A Tax Formula to Restore the Historical Effects of the Antitrust Treble Damage Provisions*, 65 MICH. L. REV. 245, 257-58 (1966).

<sup>5</sup> One of the few changes was the enactment in 1969 of I.R.C. § 186 (antitrust damages and certain other damages). Pub. L. No. 91-172, § 904(a), 83 Stat. 711 (1969). For a fuller explanation of this provision, see notes 156-65 and accompanying text *infra*.

(1) Damages for personal injuries, including damages attributable to loss of earnings or profits,<sup>6</sup> are not taxable.<sup>7</sup>

(2) Punitive damages are taxable.<sup>8</sup>

(3) Other "windfall" recoveries are also taxable.<sup>9</sup>

(4) The taxation of any other kind of recovery depends on what the recovery represents.<sup>10</sup> If the recovery represents damages for loss of capital,<sup>11</sup> it is taxable only to the extent that the damages exceed the taxpayer's basis in the capital affected.<sup>12</sup> If the recovery represents lost profits or earn-

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<sup>6</sup> Treas. Reg. § 1.104-1(c) (1956).

<sup>7</sup> I.R.C. § 104(a)(2).

<sup>8</sup> Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Treas. Reg. § 1.61-14(a) (1960).

<sup>9</sup> General Am. Investors Co. v. Commissioner, 348 U.S. 434 (1955) (recovery of insiders' profits taxable); Treas. Reg. § 1.61-14(a) (1960).

An interesting question may arise under a settlement or judgment in a class action that uses the "fluid recovery" technique to allow an individual who is a member of a class at the time of the recovery to recover against a wrongdoer even though the individual was not a member of the class at the time of the wrong. See *Daar v. Yellow Cab Co.*, 67 Cal. 2d 695, 433 P.2d 732, 63 Cal. Rptr. 724 (1967). Even if the recovery would normally be nontaxable as damages on account of personal injury or as a recovery of capital, the damages could be taxable as a windfall to the individual who recovers but who was not a member of the class at the time of the injury.

<sup>10</sup> *Lyeth v. Hoey*, 305 U.S. 188 (1938) (settlement of will contest not taxable); *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.) (recovery in excess of basis for injury to goodwill taxable), *cert. denied*, 323 U.S. 779 (1944); *Vincent v. Commissioner*, 219 F.2d 228 (9th Cir. 1955) (recovery of dividend income stolen from trust held not taxable to beneficiary). In *Vincent*, the taxpayer, who was the beneficiary of a trust, recovered \$61,000 from the estate of the trustee who had allegedly embezzled dividend income from the trust. Because of the embezzlement, the trust itself paid no tax on the dividends. The issue in the case was whether the taxpayer-beneficiary was taxable on the recovery. The Tax Court held the recovery taxable as ordinary income since it represented dividend income. *Virginia Hansen Vincent*, 18 T.C. 339 (1952). This result is not surprising since the dividends would have been taxable to the trust had it received them. Nonetheless, the Ninth Circuit reversed the Tax Court, holding that the money was not taxable to the beneficiary because the trust, not the beneficiary, would have been liable for the tax on the dividends.

<sup>11</sup> *Farmers' & Merchants' Bank v. Commissioner*, 59 F.2d 912 (6th Cir. 1932); *Highland Farms Corp.*, 42 B.T.A. 1314 (1940).

<sup>12</sup> *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944). Whether the excess is taxable as ordinary income or as capital gain depends on a number of factors, including whether the damaged asset is a capital asset. See notes 64-73 and accompanying text *infra*.

If only part of an asset has been damaged, it may be impossible to allocate basis to the affected part. When allocation is impossible and the recovery does not exceed the total basis of the asset, some courts have held that no part of the recovery is taxable. See, e.g., *Strother v. Commissioner*, 55 F.2d 626, 632-33 (4th Cir.), *aff'd on other grounds*, 287 U.S. 314 (1932). This holding is inconsistent with the apparently universal rule that the taxpayer bears the burden of proving his basis when an entire asset has been destroyed. *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944); *Telefilm, Inc.*, 21 T.C. 688, 695 (1954), *rev'd on other grounds*, 5 A.F.T.R.2d 1804 (9th Cir. 1955).

ings—whether past, present, or future—it is fully taxable.<sup>13</sup>

(5) If a recovery is taxable, it must be included in the income of a cash basis taxpayer in the year of recovery, not in the year (or years) during which the taxpayer suffered or will suffer the loss.<sup>14</sup>

(6) Identical rules of taxation apply whether the recovery results from a judgment or a settlement.<sup>15</sup>

Because the rules for taxing damages are now relatively settled, it should be a fairly simple matter for a lawyer to advise a client on the taxability of a given recovery.<sup>16</sup> Likewise, tax planning in drafting complaints or settlements should present few problems for plaintiffs' attorneys in damage actions.<sup>17</sup> Yet despite general agreement on which damages are taxable, there is still little consensus regarding the tax policies that justify the exclusion of certain recoveries from income.<sup>18</sup> This Article analyzes policy justifications for the present law and recommends alternative rules that will more appropriately effectuate rational tax policies for the inclusion or exclusion of damages from income. Two concluding sections attempt to show how these alternative rules would generally reflect and reinforce the policies of tort and contract law in the area of damages.

## I

### THE *Macomber* DEFINITION OF INCOME

The 1918 Revenue Act excluded from gross income "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal

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In cases of partial destruction, the basis of the asset will be reduced by the amount of the recovery that is nontaxable. *Inaja Land Co.*, 9 T.C. 727 (1947).

<sup>13</sup> *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944); *Nathan Agar*, 29 T.C.M. (P-H) 137 (1960), *aff'd*, 290 F.2d 283 (2d Cir. 1961).

Interest on a judgment, even if the judgment itself is nontaxable, is taxable. *Theodore Pope Riddle*, 27 B.T.A. 1339 (1933).

<sup>14</sup> *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

<sup>15</sup> I.R.C. § 104(a)(2) exempts "damages received (whether by suit or agreement)." See *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 114 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

<sup>16</sup> Cutler, *Taxation of the Proceeds of Litigation*, 57 COLUM. L. REV. 470 (1957) (summary of post-*Glenshaw Glass* rules governing taxation of damages).

<sup>17</sup> See McCaffrey, *Taxpayer's Choice in Damage Suit*, 29 TAXES 879 (1951) (suggestions for drafting complaint or settlement agreement to minimize taxes payable on recovery). See also Fouts, *Payments Received in Settlement of Litigation and Claims*, N.Y.U. INST. ON FED. TAX. 555 (1967).

<sup>18</sup> For a discussion of various theories that have been suggested to justify the exclusion of certain damages from income, see notes 39-142 and accompanying text *infra*.

injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injury or sickness."<sup>19</sup> Not surprisingly, the Solicitor of Internal Revenue sought to limit this statutory exclusion by its terms shortly after its enactment. He ruled in 1919 that money received in a libel action was taxable,<sup>20</sup> and in 1920 that a recovery for alienation of a wife's affections was also taxable on the grounds that the exclusion of "personal injuries" under the statute applied to "physical injuries only."<sup>21</sup> Since the Service's position was not unreasonable, it seemed, for a time at least, that all damage recoveries except those specifically exempted by the statute would be included in gross income.<sup>22</sup>

In 1920 the Supreme Court decided *Eisner v. Macomber*,<sup>23</sup> which defined income as "the gain derived from capital, from labor, or from both combined."<sup>24</sup> Though the *Macomber* facts did not remotely involve damages,<sup>25</sup> the holding caused a complete reversal in the Service's attitude toward the taxation of damage recoveries; two years after the decision the Solicitor of Internal Revenue ruled that damages for alienation of affections, for defamation of personal character, or for the surrender of the custody of a minor child were no longer taxable because there was "no gain, and therefore no income" from such recoveries.<sup>26</sup> The Solicitor did not offer a convincing policy justification for these new exclusions<sup>27</sup>—the items were excluded merely because they did not fall within the meaning of the term "income" as used in the statute.<sup>28</sup> This rationale seems questionable. Congress would not have needed to legislate a specific exclusion for damages in compensation for personal injuries if it had been settled that such damages were not "income" in the statutory sense.<sup>29</sup>

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<sup>19</sup> Ch. 18, § 213(b)(6), 40 Stat. 1066 (1918) (now I.R.C. § 104(a)).

<sup>20</sup> S. 957, 1 C.B. 65 (1919).

<sup>21</sup> S. 1384, 2 C.B. 71 (1920).

<sup>22</sup> For an analysis of this early Service position, see Knickerbocker, *The Income Tax Treatment of Damages: A Study in the Difficulties of the Income Concept*, 47 CORNELL L.Q. 429, 430-31 (1961).

<sup>23</sup> 252 U.S. 189 (1920).

<sup>24</sup> *Id.* at 207. This language originated in an earlier Supreme Court opinion, *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913).

<sup>25</sup> The case involved the government's attempt to tax a stock dividend.

<sup>26</sup> Sol. Op. 132, 1-1 C.B. 92, 93 (1922).

<sup>27</sup> The Solicitor stated only that the damages were nontaxable because "the right invaded is a personal right and is in no way transferable." *Id.* at 93.

<sup>28</sup> The Solicitor relied on *Macomber* in holding that "there is no gain, and therefore no income" when such damages are received. *Id.*

<sup>29</sup> The legislative history of the 1918 Revenue Act indicates that Congress was unsure

Despite the dubious grounds for extending the *Macomber* definition to the area of damage recoveries, the Solicitor's approach was supported, and even extended, by most of the subsequent cases and rulings. Damages received in an annulment of a marriage procured by fraud were held not taxable income;<sup>30</sup> subsidies paid to a railroad company by the Republic of Cuba were held excludable because they "were not made for services rendered or to be rendered";<sup>31</sup> damages paid for loss of life were held "not embraced in the general concept of the term 'income'";<sup>32</sup> punitive damages were also held excludable for the same reason.<sup>33</sup> As late as 1954 the Service itself reaffirmed this reasoning in ruling that payments for loss of life were excludable because they were "not embraced in the general concept of the term 'income.'"<sup>34</sup>

Although many of the decisions and rulings applied the *Macomber* definition literally to exclude recoveries, the courts stopped short of excluding all types of recoveries. Damages for lost profits or earnings, for example, were held taxable, unless the damages resulted from a personal injury.<sup>35</sup> Yet if a recovery is not "income"—when it is not a gain from labor or capital or from both combined—then lost profit recoveries are arguably excludable since they represent a gain that *failed* to materialize because the injured party was *prevented* from performing services or from engaging in a profitable enterprise. Indeed, very often the gravamen of the injured party's complaint is that he was prevented from realizing gains from labor or capital because of the wrongdoer's conduct. Nonetheless, the cases uniformly held that damages for loss of earnings or profits were taxable, indicating that the courts were not willing to carry the *Macomber* definition to its furthest possible extension.<sup>36</sup>

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whether damages in compensation for personal injuries were income: "Under the present law it is doubtful whether . . . damages received on account of [personal] injuries or sickness, are required to be included in gross income." H.R. REP. NO. 767, 65th Cong., 2d Sess. 9-10 (1918).

<sup>30</sup> I.T. 1852, II-2 C.B. 66 (1923).

<sup>31</sup> *Edwards v. Cuba R.R.*, 268 U.S. 628, 633 (1925). One commentator has questioned the Court's reliance on the *Macomber* definition of income to exclude these subsidies. Wright, *supra* note 2, at 177-78.

<sup>32</sup> I.T. 2420, VII-2 C.B. 123, 124 (1928).

<sup>33</sup> *Highland Farms Corp.*, 42 B.T.A. 1314, 1322 (1940).

<sup>34</sup> Rev. Rul. 54-19, 1954-1 C.B. 179, 180.

<sup>35</sup> See Plumb, *supra* note 3, at 223-24.

<sup>36</sup> Cases involving damages for patent infringement provide an interesting example. In such cases the damages of the injured party are often not computed with reference to profits lost as a result of the infringement, but are instead measured by the profits that the infringer made as a result of the infringement. See, e.g., *Triplex Safety Glass Co. v. Latchum*,

Because many of the early cases and rulings exempting damages were based not on tax policy, but simply on the Supreme Court's definition of the word "income," they shed little light on the policies justifying the exclusion of certain damage recoveries. Furthermore, when the Supreme Court decided to revise its definition of the word "income," as it did sub silentio in *Glenshaw Glass*,<sup>37</sup> the intellectual support for many of the earlier holdings on damages collapsed.<sup>38</sup>

## II

### THE SECTION 104(a)(2) EXEMPTION

#### A. *Emotional Factors Behind the Exemption*

The tax exemption for damages received as compensation for personal injuries or sickness was first enacted in 1918.<sup>39</sup> Yet, even now, the policy reasons for the exclusion are unclear. This has prompted many commentators to conclude that the exemption is impossible to justify on logical grounds, and that it is rooted instead in "emotional and traditional" factors.<sup>40</sup> Under this view the exemption represents "the feeling that the taxation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed."<sup>41</sup>

Although sympathy for the injured party is undoubtedly one reason for the exemption, this explanation is, as the commentators

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44 F. Supp. 436 (D. Del.), *aff'd*, 131 F.2d 1023 (3d Cir. 1942) (per curiam). Although it is difficult to square taxing such damages with the *Macomber* definition of income, courts have held that such damages are taxable. *Id.*; W.W. Sly Mfg. Co., 24 B.T.A. 65 (1931). In *Triplex*, the taxpayer also argued that because the infringer was taxed on the profits he improperly received, the injured party should not be taxed on the same profits. 44 F. Supp. at 438. The court rejected this argument in holding that the tax liability of the injured party was not affected by the liability of the infringer, even if the very same profits would be taxed twice. In any event, because the infringer receives a deduction for the amount he pays to the injured party, the profits are not taxed twice. For a general discussion of the deductibility of damage payments, see Plumb, *Income Tax on Gains and Losses in Litigation* (pt. 2), 26 CORNELL L.Q. 16 (1940).

<sup>37</sup> See Wright, *supra* note 2, at 179-201 (summary of developments before *Glenshaw Glass* that facilitated Court's tacit overruling of *Macomber* in damage area).

<sup>38</sup> Despite the erosion of intellectual support for some of these holdings, they remain good law. The Service has, for example, largely reaffirmed Solicitor's Opinion 132. Rev. Rul. 74-77, 1974-1 C.B. 33. See notes 30-34 and accompanying text *supra*.

<sup>39</sup> See note 19 *supra*.

<sup>40</sup> Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 626 (1952); Comment, *Tax Treatment of Post-termination Personal Injury Settlements*, 61 CALIF. L. REV. 1237 (1973).

<sup>41</sup> Harnett, *supra* note 40, at 627.

admit, neither legally nor logically convincing.<sup>42</sup> Even assuming *arguendo* that it would be offensive to tax a recovery for pain and suffering, this rationale does not justify extending the exemption to damages for defamation of a personal nature,<sup>43</sup> damages for breach of promise,<sup>44</sup> and damages for fraud and deceit<sup>45</sup>—none of which is likely to involve personal anguish.

On the other hand, if sympathy for the victim is the true basis for the exemption, the exclusion does not go far enough. Although one commentator has argued that injury to one's business reputation may be a "less serious blow to the victim,"<sup>46</sup> such an injury can be as emotionally upsetting as damage to personal reputation.<sup>47</sup> Some individuals treasure their personal reputations; others, their business reputations. That the tax system favors one over the other is a puzzle.<sup>48</sup>

### B. *Difficulty of Allocation*

Even if the exemption for personal injury recoveries can be explained as an emotional response to the plight of injured taxpayers, the blanket exemption for recoveries of lost earnings or profits cannot be so justified because the injured party receives tax-free that which would have been taxable but for the injury.<sup>49</sup> It

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<sup>42</sup> *Id.*; Comment, *supra* note 40.

<sup>43</sup> C.A. Hawkins, 6 B.T.A. 1023 (1927).

<sup>44</sup> Lyle McDonald, 9 B.T.A. 1340 (1928).

<sup>45</sup> I.T. 1852, II-2 C.B. 66 (1923).

<sup>46</sup> See Comment, *supra* note 40, at 1238 n.9.

<sup>47</sup> The leading early case on damages for defamation apparently did not distinguish between personal reputation and business reputation. C.A. Hawkins, 6 B.T.A. 1023 (1927). At least one early commentator thought damages for injury to both were nontaxable. Plumb, *supra* note 3, at 234 n.80.

<sup>48</sup> Being called a Communist, for example, may damage one's personal reputation, business reputation, or both. Damages for the latter are taxable (Paul Draper, 26 T.C. 201 (1956)), while damages for the former are exempt (I.R.C. § 104(a)(2)), even though the emotional upset suffered may be the same in both cases.

<sup>49</sup> See note 6 and accompanying text *supra*. A recent ruling represents an unusual exception to the rule that damages for lost earnings due to a personal injury are not included in gross income. Rev. Rul. 72-341, 1972-2 C.B. 32. An employer was required to divide a specified sum among employees who suffered a loss as a result of the employer's discriminatory employment practices. The amount paid to each employee was based on a formula that considered the difference between the employee's actual earnings and what his earnings would have been had he not been discriminated against. It is difficult to understand why the payment is not exempt under § 104(a)(2) as damages received on account of a personal injury, especially since the Service ruled in 1955 that payments made by the United States under the War Claims Act, 50 U.S.C. app. § 2005(d)(2)(A)-(B) (1970) (originally enacted as ch. 826, § 6, 62 Stat. 1244 (1948), as amended, ch. 167, § 2, 66 Stat. 48 (1952)) to compensate for violation of a taxpayer's rights as a German prisoner of war were nontaxable. Rev. Rul. 55-132, 1955-1 C.B. 213; see Rev. Rul. 56-518, 1956-2 C.B. 25. Apparently the distinction is that the payments in the former ruling were computed with reference to the



has been suggested that damages for lost earnings are exempt because it would be difficult for the taxpayer to allocate between damages for lost earnings and nontaxable damages such as pain and suffering.<sup>50</sup> The blanket exemption does, of course, eliminate the administrative difficulty of separating the various elements of a recovery. Yet taxpayers and courts frequently confront the problem in allocating damages for a business injury.<sup>51</sup> In a typical business injury situation, recovery may consist of damages for lost profits, damages for injury to capital (goodwill), and punitive damages. Of these, only damages for injury to goodwill are excludable, and only to the extent of the taxpayer's basis in the goodwill affected.<sup>52</sup> To obtain an exclusion, therefore, the taxpayer must establish the amount of recovery allocable to,<sup>53</sup> and his basis in, the goodwill.<sup>54</sup>

Likewise, it is frequently necessary to allocate damages in the personal injury context.<sup>55</sup> Sometimes an allocation must be made between compensatory (nontaxable) and punitive (taxable) damages.<sup>56</sup> Occasionally the Service and a taxpayer disagree about whether damages compensate for personal injury (nontaxable) or for loss of earnings in a business context (taxable).<sup>57</sup> Since courts already allocate damages for tax purposes in both business and

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taxpayer's lost earnings. But under § 104(a)(2) the crucial question is whether the injury is a personal injury, not whether damages are computed by reference to lost earnings that would otherwise be taxable. See notes 55-57 and accompanying text *infra*.

<sup>50</sup> Comment, *supra* note 40, at 1237.

<sup>51</sup> The difficulties of allocating among types of damages in a business context are well illustrated by the opinions of the Tax Court and the Ninth Circuit in *Ione Thomson*, 34 T.C.M. (P-H) 1317 (1965), *aff'd*, 406 F.2d 1006 (9th Cir. 1969).

<sup>52</sup> See notes 10-13 and accompanying text *supra*.

<sup>53</sup> The taxpayer usually has the burden of proof on this issue. *Sager Glove Corp. v. Commissioner*, 311 F.2d 210, 211 (7th Cir. 1962). The Tax Court has occasionally ruled that a reasonable approximation of the recovery portion allocable to goodwill must be made when the evidence is unclear. See, e.g., *Telefilm, Inc.*, 21 T.C. 688 (1954), *rev'd on other grounds*, 5 A.F.T.R.2d 1804 (9th Cir. 1955). This approach considerably relaxes the taxpayer's burden of proof. It is clear, however, that the form of a transaction will not conclusively determine the nature of the recovery. Cf. *Estate of J.T. Longino*, 32 T.C. 904, 906 (1959) (payments taxable as ordinary income even though settlement agreement drafted in form of sale).

In the case of antitrust recoveries, the Service has eased the taxpayer's burden of proof considerably when the issue is whether the payments received represent compensatory or punitive damages. See Rev. Proc. 67-33, 1967-2 C.B. 659.

<sup>54</sup> The taxpayer has the burden of proof on this issue. See note 12 *supra*.

<sup>55</sup> See, e.g., cases cited in note 57 *infra*. A recent commentary reviewing the cases concludes that courts should require more proof from taxpayers who claim that a settlement represents nontaxable damages for personal injury. Comment, *supra* note 40, at 1252-53.

<sup>56</sup> Rev. Rul. 58-418, 1958-2 C.B. 18.

<sup>57</sup> See, e.g., *Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965); *Dudley G. Seay*, 58 T.C. 32 (1972); *Leo Dalbo*, 38 T.C.M. (P-H) 1270 (1969); *Nathan Agar*, 29 T.C.M. (P-H) 137 (1960).

personal injury contexts, the blanket exclusion for all damages for personal injury, including loss of earnings, cannot be justified solely on the grounds of administrative convenience.

### III

#### RECOVERY OF CAPITAL

An early income tax decision, *Burnet v. Logan*,<sup>58</sup> established that the recovery of capital is not a taxable event.<sup>59</sup> A similar principle applies when damages represent compensation for loss of capital.<sup>60</sup>

##### A. *The Business Asset*

When a taxpayer purchases a business, part of the purchase price can be allocated to goodwill. If a tortfeasor, *e.g.*, an unfair competitor, destroys all or part of the goodwill, then, given the holding of *Burnet v. Logan*,<sup>61</sup> the damages received as compensation for destruction of the goodwill are not taxed,<sup>62</sup> except to the extent that the damages exceed the taxpayer's basis in the goodwill.<sup>63</sup>

Determining appropriate taxation on the excess is a more difficult question. Usually the gain derived from the sale or exchange of a capital asset<sup>64</sup> like goodwill,<sup>65</sup> held for more than nine months,<sup>66</sup> is long-term capital gain,<sup>67</sup> and is taxed at favorable rates.<sup>68</sup> Even in the absence of a sale or exchange, the gain on the involuntary conversion or theft of a depreciable asset may be taxable as a long-term capital gain.<sup>69</sup> But if goodwill is injured by the wrongful conduct of a tortfeasor, there is a strong possibility that the excess of the recovery over the taxpayer's basis will be taxable

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<sup>58</sup> 283 U.S. 404 (1931).

<sup>59</sup> *Id.* at 411-14. *See* Eisner v. Macomber, 252 U.S. 189, 206-07 (1920).

<sup>60</sup> *See* notes 11-12 and accompanying text *supra*.

<sup>61</sup> 283 U.S. at 412-13.

<sup>62</sup> *State Fish Corp.*, 48 T.C. 465, 477 (1967).

<sup>63</sup> *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 114 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

<sup>64</sup> I.R.C. § 1221.

<sup>65</sup> Rev. Rul. 55-79, 1955-1 C.B. 370.

<sup>66</sup> I.R.C. §§ 1222(3), 1223. For taxable years beginning after December 31, 1977, the holding period has been increased to one year. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1402, 90 Stat. 1731.

<sup>67</sup> I.R.C. § 1222(3).

<sup>68</sup> I.R.C. §§ 1201, 1202. Capital gains are subject to the minimum tax on items of tax preference. *Id.* § 57(a)(9).

<sup>69</sup> *Id.* § 1231.

as ordinary income, since there has been no sale or exchange<sup>70</sup> and goodwill is not a depreciable asset.<sup>71</sup>

The usual requirement of a sale or exchange for a transaction to qualify for capital gain treatment has been persuasively criticized.<sup>72</sup> The rule makes even less sense in the damage recovery area, since a taxpayer may be taxed at ordinary income rates on a gain which would have been taxed as a capital gain had he sold the asset. Since there is no justification for taxing a gain more heavily when the taxpayer has been compelled against his will to realize it,<sup>73</sup> Congress should provide that any gain from damages awarded upon the destruction of a capital asset be taxable as a capital gain.

### B. *Recovery of Expenditures*

If a taxpayer incurs expenses as a result of an injury and the wrongdoer reimburses him for those expenses, the amount of the reimbursement is not taxable<sup>74</sup> unless the taxpayer took a deduction for the expenses in an earlier taxable year.<sup>75</sup> In a leading case,

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<sup>70</sup> One commentator has suggested that the excess of the recovery over the injured party's basis in the goodwill should be taxable as ordinary income. Cutler, *supra* note 16, at 475 n.29. This is clearly correct under current law, given the "sale or exchange" requirement for favorable capital gains treatment. I.R.C. § 1222(3). See *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249-50 (1941). A number of leading cases treat the gain as ordinary income. See, e.g., *Harold S. Smith*, 50 T.C. 273, 285 (1968); *Ralph A. Boatman*, 32 T.C. 1188, 1192 (1959). Some cases, apparently disregarding the sale or exchange requirement, treat the excess as capital gain. E.g. *Big Four Industries, Inc.*, 40 T.C. 1055, 1060 (1963). See *R.J. Durkee*, 18 T.C.M. (P-H) 610, 612 (1949). Under current law these later cases are probably wrong.

<sup>71</sup> Treas. Reg. § 1.167(a)-3 (1956).

<sup>72</sup> Note, *The Elements of a Section 117 "Sale or Exchange,"* 53 COLUM. L. REV. 976, 990-91 (1953).

<sup>73</sup> Indeed, it is arguable that a gain on an involuntary conversion should be taxed less heavily. See note 92 and accompanying text *infra*.

<sup>74</sup> See *Edward H. Clark*, 40 B.T.A. 333, 335 (1939), *acq.* 1957-1 C.B. 4; I.R.C. § 104(a)(2).

<sup>75</sup> I.R.C. § 104(a); Rev. Rul. 57-47, 1957-1 C.B. 23. The inclusion of the reimbursement is defensible on the grounds that the taxpayer, in effect, understated his taxable income in the earlier year by taking the deduction. Since the annual accounting principle prohibits reopening the earlier year, the reimbursement should be taxable when the taxpayer receives it. See *Burnet v. Sanford & Brook Co.*, 282 U.S. 359 (1931).

One decision involving a damage recovery probably improperly allowed exclusion of a reimbursement of expenses even though the taxpayer deducted the expenses in an earlier year. See *Cox v. Kraemer*, 88 F. Supp. 835 (D. Conn. 1948). If, however, the taxpayer has received no tax benefit from the deduction—e.g., if he had no taxable income against which to offset the deduction—the reimbursement will probably be excludable. See *Alice Phelan Sullivan v. United States*, 381 F.2d 399, 401-02 (Ct. Cl. 1967) (dictum) (tax-benefit exception to usual rule of inclusion of previously deducted items supported); *California & Hawaiian Sugar Ref. Corp. v. United States*, 311 F.2d 235, 237-39 (Ct. Cl. 1962) (reimbursement of unconstitutional taxes held nontaxable since at time of payment of taxes

*Edward H. Clark*,<sup>76</sup> the taxpayer overpaid his federal income taxes because of his counsel's erroneous tax advice. When the lawyer reimbursed the taxpayer for the overpayment, the Service sought to tax the reimbursement. The Board of Tax Appeals held for the taxpayer, in part because the taxpayer was no better off economically than he would have been if the lawyer had not made the mistake.<sup>77</sup> A number of subsequent Internal Revenue Service rulings have endorsed this reasoning.<sup>78</sup> The theory of this line of cases and rulings is sound. When a taxpayer is reimbursed for an expense that he incurred because of an injury, he is simply being made whole without any economic gain. In a sense, such a recovery is compensation for a loss that impaired the injured party's capital and, like other recoveries for injury to capital,<sup>79</sup> should not be taxable.<sup>80</sup>

### C. Human Capital

Some authorities have suggested that personal injury recoveries are, in effect, recoveries for injury to capital<sup>81</sup> because the

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taxpayer was tax-exempt entity, and therefore not entitled to deduct them); I.R.C. § 111; Treas. Reg. § 1.111-1 (1956).

<sup>76</sup> 40 B.T.A. 333 (1939), *acq.* 1957-1 C.B. 4.

<sup>77</sup> See *id.* at 335. The Board also relied on the now questionable *Macomber* definition of income. See notes 19-38 and accompanying text *supra*.

<sup>78</sup> See, e.g., Rev. Rul. 60-279, 1960-2 C.B. 11 (reimbursement of relocation expenses not taxable); Rev. Rul. 57-60, 1957-1 C.B. 25, *modified*, Rev. Rul. 60-280, 1960-2 C.B. 12 (school board's required reimbursement of transportation expenses not income to parent).

<sup>79</sup> See notes 11 & 60-62 and accompanying text *supra*.

<sup>80</sup> Under this theory the taxpayer usually has no gain because his "basis" is the amount of expenses that he incurred. If his recovery for the expenses exceeds the amount actually expended, the excess should be taxable. See note 12 and accompanying text *supra*.

<sup>81</sup> In *Glenshaw Glass*, the Court interpreted the Service's position to be that personal injuries were "nontaxable on the theory that they roughly correspond to a return of capital." 348 U.S. at 432 n.8. The Court relied in part on Solicitor's Opinion 132, 1-1 C.B. 92 (1922), to support this finding. In that opinion, the Solicitor did not rely on a return of capital theory; instead, he stated that damages for invasion of a personal right should not be taxable because there could be "no correct estimate of the money value of the invaded rights." *Id.* at 93. The validity of this reasoning is doubtful in light of the subsequent decision in *United States v. Davis*, 370 U.S. 65 (1962), in which the taxpayer used shares of stock to satisfy his wife's marital claims against him. The government argued that the appreciation in the value of the stock during ownership was taxable to the taxpayer. The taxpayer argued that the appreciation was not taxable because the value of the marital rights relinquished in return for the stock was indeterminable. The Court held for the government on the ground that the value of the wife's rights could be assumed to be equal to the value of the property accepted in exchange for those rights.

Similar reasoning would support a finding that the amount of a damage settlement (or of a jury award) in a personal injury action is a fair approximation of the value of the invaded rights. After *Davis*, therefore, the difficulty of valuing rights invaded should not, in itself, be a bar to taxation of a personal injury recovery.

human body or an individual's reputation are arguably forms of "capital." In *C.A. Hawkins*,<sup>82</sup> the Board of Tax Appeals held that damages for personal defamation were not taxable on the grounds that such damages represented an attempt to "make the plaintiff whole as before the injury."<sup>83</sup> The Solicitor of Internal Revenue, interpreting an earlier opinion of the Attorney General exempting the proceeds of an insurance policy, opined that "the human body is a kind of capital" and "the proceeds of the insurance policy really [represent] a conversion of the capital lost through the injury."<sup>84</sup>

There are several objections to this reasoning. First, the human capital argument does not explain why personal injury damages that are clearly allocable to loss of earnings are not taxable.<sup>85</sup> If the analogy to a nontaxable return of capital is correct, then the statutory exemption<sup>86</sup> should not include lost earnings<sup>87</sup> which, unlike a return of capital, would be taxable when received. In addition, if a damage recovery does indeed compensate for the destruction of human capital, it would seem that the excess of recovery over the taxpayer's basis in the human capital should be taxable. Certainly it would be difficult, if not impossible, to assign a cost basis to human capital.<sup>88</sup> But the difficulty of assigning a basis to human capital might necessitate taxation of the entire recovery, since the sale of an asset that has a zero basis is fully taxable.<sup>89</sup>

In no other tax situation is an individual allowed to use his basis in human capital to reduce taxable gain.<sup>90</sup> Admittedly, the

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<sup>82</sup> 6 B.T.A. 1023 (1927).

<sup>83</sup> *Id.* at 1025. The Board also supported the exclusion on the grounds that damages for defamation are not "income" under the *Macomber* definition. *Id.* at 1024. See notes 23-29 and accompanying text *supra*.

<sup>84</sup> S. 1384, 2 C.B. 71, 72 (1920). The British apparently exempt damages for personal injury on a type of human capital theory: "[A] person whose earning capacity is wholly or partly destroyed loses the whole or part of a capital asset . . ." Dworkin, *Damages and Tax—A Comparative Survey* (pt. 1), 1967 BRIT. TAX REV. 315, 328 (emphasis added).

<sup>85</sup> See notes 6-7 and accompanying text *supra*.

<sup>86</sup> I.R.C. § 104(a)(2).

<sup>87</sup> It is curious that the British exemption of damages for lost earnings has apparently been defended on the human capital theory. See Dworkin, *supra* note 84, at 328 (British theory criticized).

<sup>88</sup> See Plumb, *supra* note 3, at 234. The problem of determining basis in human capital may arise in the context of a transfer of bodily parts. For an amusing analysis of the tax issues involved in such transfers, see Note, *Tax Consequences of Transfers of Bodily Parts*, 73 COLUM. L. REV. 842 (1973). The student commentator concludes that a likely outcome regarding the tax consequences of such transfers is "that the Commissioner and the courts will find these expenditures non-capitalizable, hold that the entire body has a zero basis, and tax the entire proceeds of any anatomical sale." *Id.* at 855.

<sup>89</sup> See Harnett, *supra* note 40, at 627.

<sup>90</sup> Living expenses, comprising most of one's basis in human capital, are nondeductible under current law. See I.R.C. § 262. Educational expenses are also nondeductible. Treas.

fact that the victim is forced to convert his human capital into cash or other property distinguishes the personal injury case. As a general rule, however, the tax consequences of an involuntary conversion of property are no different from those of a voluntary sale,<sup>91</sup> unless Congress specifically provides for more favorable tax results.<sup>92</sup> And there is no evidence that Congress intended the exemption for personal injury recoveries as a specific exception to the tax rules governing realizations from involuntary conversions.<sup>93</sup>

#### D. *Compensation for a Nontaxable Item*

The most convincing argument for part of the exclusion is that damages intended to compensate for losses that the taxpayer would have enjoyed tax-free should also be tax-free.<sup>94</sup> One commentator has argued that an early Supreme Court opinion allowing a wife to exclude alimony from her income was correct because alimony represents "the portion of the *husband's* estate or income to the enjoyment of which the wife is equitably entitled,"<sup>95</sup> and which she would have enjoyed tax-free, but for the divorce.<sup>96</sup> Under current law the exclusion from the wife's income of a lump-sum marital settlement<sup>97</sup> might be defended on the same theory.

Other examples suggest that this reasoning has considerable force. Damages for defamation of character are exempt<sup>98</sup> arguably because a taxpayer would enjoy his reputation tax-free; damages for invasion of privacy are exempt<sup>99</sup> because maintaining one's

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Reg. § 1.162-5(b)(1), T.D. 6918, 1967-1 C.B. 37. The Tax Court has ruled, in at least one case, that a taxpayer may not depreciate the cost of receiving an engineering degree. *See, e.g.,* Nathaniel A. Denman, 48 T.C. 439, 444-46 (1967).

<sup>91</sup> The Internal Revenue Code provides for nonrecognition of gain on an involuntary conversion of property only if the taxpayer meets the narrow requirements of I.R.C. § 1033. *See, e.g.,* Clifton Inv. Co. v. Commissioner, 312 F.2d 719, 721-22 (6th Cir.), *cert. denied*, 373 U.S. 921 (1963).

<sup>92</sup> *See* I.R.C. § 1033(a) (nonrecognition of gain on involuntary conversion of property under certain circumstances); *id.* § 1231(a) (capital gain or ordinary loss on involuntary conversion of certain property). Section 1033 does not allow a permanent exemption from taxation because it provides for a basis adjustment that will usually result in a gain when the property is sold (assuming the property retains its value at the time of the conversion). I.R.C. § 1033(b).

<sup>93</sup> *See* H.R. REP. NO. 767, 65th Cong., 2d Sess. 9-10 (1918).

<sup>94</sup> *See* United States v. Kaiser, 363 U.S. 299, 311 (1960) (concurring opinion, Frankfurter, J.).

<sup>95</sup> *See* Plumb, *supra* note 3, at 235 (emphasis in original).

<sup>96</sup> Under current law, alimony—in contrast to a lump-sum settlement—is taxable to the wife and deductible by the husband. I.R.C. §§ 71, 215.

<sup>97</sup> I.R.C. § 71(c).

<sup>98</sup> C.A. Hawkins, 6 B.T.A. 1023 (1927).

<sup>99</sup> *See* Meyer v. United States, 173 F. Supp. 920, 923-24 (E.D. Tenn. 1959) (dictum)

privacy is not a taxable event.<sup>100</sup> So, too, damages in compensation for a violation of an individual's civil rights should not be taxed because the injured party would not have been taxed if his rights had been respected.<sup>101</sup> This argument is more persuasive than the human capital argument because it eliminates the problem of computing basis in human capital. Nonetheless, like the human capital argument, it also fails to explain why damages for loss of earnings are exempt, since the earnings *would* be taxable income if received.

#### IV

##### BUNCHING OF INCOME

###### A. *Periodicity*

One line of cases suggests that damages may not be taxable because, as a periodical return to the taxpayer, they do not constitute "income." An early Supreme Court opinion, for example, justified the exemption for the proceeds of a life insurance policy in the following terms:

The benefit to be gained by death has no periodicity. It is a substitution of money value for something permanently lost either in a house, a ship, or a life. Assuming without deciding that Congress could call the proceeds of such indemnity, income, and validly tax it as such, we think that in view of the popular

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(§ 104(a)(2) exclusion of damages for invasion of privacy supported); 1 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 5.11, at 39 (1974).

<sup>100</sup> But if one contracts away his right of privacy, the amount of compensation he receives in return is taxable. See *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962) (dictum); *Ehrlich v. Higgins*, 52 F. Supp. 805, 808-09 (S.D.N.Y. 1943) (dictum). Under the statute these decisions are probably correct because payments received in advance for giving up one's privacy are not "damages received . . . on account of personal injuries." I.R.C. § 104(a)(2) (emphasis added). The major factual distinction between these cases is that the tort victim is compelled to settle for damages while the contractor voluntarily chooses to give up his right of privacy. See note 93 and accompanying text *supra*. Yet the current rules may encourage a prospective victim not to contract away his privacy in the expectation that his privacy will be invaded, thereby giving him an action for tax-exempt damages. The *Ehrlich* court analogized payments for invasion of privacy to taxable payments for a covenant not to compete. 52 F. Supp. at 809. The payments are distinguishable, however, because a covenantor would normally be taxed on the profits earned from competition, while an individual's privacy right is not taxable.

<sup>101</sup> See Rev. Rul. 55-132, 1955-1 C.B. 213 (prisoner-of-war payments not income). But if damages are computed by reference to the taxpayer's lost earnings (e.g., in cases of employment discrimination), the Service takes the position that the damages are taxable; the earnings would have been received and would have been taxable but for the discrimination. See Rev. Rul. 72-341, 1972-2 C.B. 32. Theoretically this distinction is convincing, but under current law the Service's position may be unfounded. See note 49 *supra*.

conception of the life insurance as resulting in a single addition of a total sum to the resources of the beneficiary, and not in a periodical return, such a purpose on its part should be express, as it certainly is not here.<sup>102</sup>

The Court's argument rests largely on the idea that "a person who receives value only sporadically is not in the same circumstances as a person who receives the identical value from a recurring source."<sup>103</sup> At least one decision involving damages explicitly endorsed this argument in holding that damages for defamation were not income,<sup>104</sup> and the early cases<sup>105</sup> holding that windfalls did not constitute income seem to rest on the same premise.

Despite these early decisions, the notion that periodical returns do not constitute income was persuasively criticized: "[I]t may be concluded with equal logic that the [periodical] receipts should be taxed at an even higher rate, for the recipient does not depend upon them for subsistence . . . . In addition, no distinction is made between the sporadic income of a prize fighter and the stable income of a college professor."<sup>106</sup> With the *Glenshaw Glass* decision, the Supreme Court rejected its earlier reasoning in holding that items such as punitive damages and other windfalls are income even though they are not received on a regular basis.<sup>107</sup>

### B. *Consequences of Income-Bunching*

The federal income tax has a highly progressive rate schedule with marginal rates on taxable income for individuals beginning at fourteen percent and increasing up to a maximum of seventy percent.<sup>108</sup> The progressivity of federal income tax rates creates a serious problem for the taxpayer who receives a lump-sum damage settlement or judgment in one year, which compensates for the loss

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<sup>102</sup> *United States v. Supplee-Biddle Hardware Co.*, 265 U.S. 189, 195 (1924).

<sup>103</sup> Comment, *Taxation of Found Property and Other Windfalls*, 20 U. CHI. L. REV. 748, 753 (1953).

<sup>104</sup> *C.A. Hawkins*, 6 B.T.A. 1023, 1025 (1927).

<sup>105</sup> *Central R.R. v. Commissioner*, 79 F.2d 697 (3d Cir. 1935); *Telefilm, Inc.*, 21 T.C. 688 (1954), *rev'd*, 5 A.F.T.R.2d 1804 (9th Cir. 1955).

<sup>106</sup> Comment, *supra* note 103, at 753 (footnotes omitted).

<sup>107</sup> The periodicity argument would suggest that some other items of income, such as gains on the casual sale of property, should be exempt, since they are realized only sporadically. See L. SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 25 (1951).

<sup>108</sup> I.R.C. § 1. The rate for corporations is currently either 20%, 22%, or 48%; for taxable years ending after December 31, 1977, the rate is either 22% or 48%. See *id.* § 11. Because the tax rate for corporations is less progressive than the rate for individuals, the deleterious effects of progression are not as marked.



of earnings or profits over a period of years. Consider this highly simplified example.<sup>109</sup> Suppose that an unfair competitor destroys the business of an individual, unmarried taxpayer, whose business earnings had been \$50,000 annually through the 1975 taxable year. The injury causes his business income to decline to zero in 1976. The wrongdoer agrees to settle with the injured party for a sum which includes \$250,000 in anticipated profits from 1976 to 1980. The \$250,000 is paid in 1977. Since the settlement is taxed entirely in the year it is received,<sup>110</sup> the injured party's tax liability on the lump-sum settlement is \$158,090.<sup>111</sup> By contrast, if the business had not been injured and the taxpayer had continued to earn \$50,000 each year from 1976 through 1980, his total tax liability would have been \$100,950.<sup>112</sup> Thus, the lump-sum settlement cost the taxpayer an additional tax liability of \$57,140.<sup>113</sup>

The relationship of this "bunching of income"<sup>114</sup> problem to the periodicity argument is apparent. When a taxpayer receives several years' worth of earnings in one year, a major tax inequity results. It is possible, although not likely,<sup>115</sup> that the exemption for damages in compensation for personal injury, including loss of earnings, represents a recognition by Congress that in a progressive tax system it is unfair to tax in one year a settlement that compensates for earnings over an extended period. If the income-bunching problem is a justification for favorable tax treatment, however, then the exemption arguably does not go far enough, since it does not embrace damages for loss of earnings caused by a business injury.<sup>116</sup>

The Internal Revenue Code now contains income-averaging

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<sup>109</sup> This example assumes that the taxpayer has no income other than the damage recovery and that he has no deductions to offset the damages for lost profits. Although this is obviously an unrealistic set of facts, the argument would remain the same unless the dollar value of deductions in the year of the recovery was sufficient to offset the effects of progression. This would be an atypical situation.

<sup>110</sup> See note 14 and accompanying text *supra*.

<sup>111</sup> I.R.C. § 1(c) (tax on first \$100,000 is \$53,090 plus 70% of the excess).

<sup>112</sup> *Id.* (tax on first \$44,000 is \$16,590 plus 60% of the excess or a total of \$20,190 per year).

<sup>113</sup> For the purpose of analysis, this example ignores the possible advantages to the taxpayer of having received the money in 1977 rather than from 1976 through 1980.

<sup>114</sup> At least two commentators have discussed the income-bunching problem. See Cutler, *supra* note 16, at 476-80; Harnett, *supra* note 40, at 614-15. The Cutler article, however, pre-dates the current averaging provisions of the Code (I.R.C. §§ 1301-1305). See notes 117-30 and accompanying text *infra*.

<sup>115</sup> The legislative history of the Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919) (repealed 1939), reveals no such congressional intent. See H.R. REP. No. 767, 65th Cong., 2d Sess. 9-10 (1918).

<sup>116</sup> See note 13 and accompanying text *supra*.

provisions that lessen the unfavorable tax consequences of a lump-sum settlement.<sup>117</sup> Although these provisions now prescribe averaging for all types of income, not only damages, they were designed in part to mitigate the tax inequity caused by income-bunching damage settlements and judgments.<sup>118</sup> The averaging provisions aid the taxpayer to some extent, but they still do not reduce tax liability to the pre-injury level. One problem is that averaging is not available to corporations.<sup>119</sup> Moreover, the averaging provisions do not entirely eliminate the deleterious effects of progression, even for individuals.<sup>120</sup> Thus, in the example discussed above, the averaging provisions would reduce the taxpayer's liability to \$131,400<sup>121</sup>—less than the one-year tax liability (\$158,090), but still far in excess of the \$100,950 he would have paid over the five-year earnings period had he not been injured.<sup>122</sup>

The averaging provisions do not completely eliminate the inequity caused by progression for a number of reasons. First, the provisions only allow a taxpayer to average the excess of his income for the taxable year over 120 percent of his average base-period income.<sup>123</sup> To the extent of twenty percent of base-period income, therefore, the averaging provisions are inoperative. Second, and more important in the example under discussion, the settlement is

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<sup>117</sup> I.R.C. §§ 1301-1305.

<sup>118</sup> See, e.g., Int. Rev. Code of 1939, ch. 757, § 721, 54 Stat. 986 (averaging of judgment or award for excess profits tax purposes); Int. Rev. Code of 1939, ch. 63, § 119(a), 58 Stat. 39 (adding § 107(d)) (now I.R.C. § 1303) (averaging of settlement or judgment for back pay for income tax purposes). See Cutler, *supra* note 16, at 484-97, for an excellent survey of the legislative history of the averaging provisions prior to the adoption of the current provisions.

<sup>119</sup> See I.R.C. § 1301 ("If an eligible individual . . .") (emphasis added).

<sup>120</sup> Income-bunching is usually not as serious a problem for a corporation. First, the corporate rates, currently either 20%, 22%, or 48%, are not as steeply progressive as the rates on the income of an individual. Second, the 48% rate currently begins at \$50,000 of taxable income (\$25,000 for taxable years ending after December 31, 1977) and remains at 48% regardless of the amount of the corporation's income. See note 108 *supra*.

<sup>121</sup> Under the averaging provisions, the individual's tax for 1977 is equal to five times the increase in tax under I.R.C. § 1 that would result from adding 20% of his "averageable income" to 120% of "average base period income." I.R.C. § 1301.

In the example under discussion, the "base period" is 1973 through 1976. *Id.* § 1302(c)(2). "Average base period income" is \$37,500 (profits of \$50,000 a year during 1973, 1974, and 1975 averaged over the "base period"). *Id.* § 1302(b)(1). One hundred and twenty percent of "average base period" is \$45,000 and "averageable income" is \$205,000 (1977 income of \$250,000 less "average base period income"). *Id.* § 1302(a)(1). Twenty percent of "averageable income" is \$41,000. The tax on \$86,000 (\$45,000 plus \$41,000) is \$45,870; the tax on \$45,000 is \$19,590. *Id.* § 1(c). The "increase in tax" under § 1301 is \$26,280 and the individual's tax liability for 1977 is five times that increase (\$131,400).

<sup>122</sup> See note 112 and accompanying text *supra*.

<sup>123</sup> I.R.C. § 1301.

averaged back over the four years from 1973 through 1976,<sup>124</sup> which includes a period (1973-1975) before the unfair competition took place, and during which the taxpayer was making his usual annual profits of \$50,000. To the extent that the settlement is thrown back into his high income years, the advantages of averaging are reduced. Finally, the current averaging provisions do not allow the taxpayer to average forward over the future years for which he is receiving compensation.<sup>125</sup> In the example given, \$150,000 of the settlement is meant to compensate for future earnings during 1978, 1979, and 1980—years to which the taxpayer is not entitled to average.

The averaging provisions, therefore, do not entirely eliminate the inequity resulting from the progressive taxation of lump-sum recoveries for loss of earnings. Of course, other taxpayers—*e.g.*, employees who receive large bonuses or taxpayers who realize unusual capital gains—are sometimes unfairly treated under the present provisions for averaging income. In the case of damage recoveries, however, the taxpayer's claim to more favorable treatment than under the general rule is stronger because the taxpayer has been *forced* to realize income in one year as a result of the wrongful intervention of a third party. Under such circumstances, his claim to total relief from the effects of progression is rather compelling.<sup>126</sup>

An alternative to the present limited averaging of damages would allow the taxpayer to allocate the recovery to the taxable years during which his income was or will be reduced because of the injury. It is unlikely, however, that the Service would accept this solution since it would offend the annual accounting principle and defeat its administrative advantages.<sup>127</sup> Not only would taxes for prior years have to be recomputed, but the computation and payment of tax on that part of the recovery allocable to future earnings would have to be deferred until the years affected.<sup>128</sup> As a

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<sup>124</sup> *Id.* § 1302(c)(2).

<sup>125</sup> *Id.* §§ 1301, 1302(c)(2).

<sup>126</sup> See text accompanying notes 91-93 *supra*.

<sup>127</sup> "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931). See note 14 and accompanying text *supra*.

<sup>128</sup> The early prototypes of the current averaging provisions required the taxpayer to recompute his tax liability for the earlier years, during which his income was reduced because of the injury, by apportioning the damage recovery among those years. But even these prototypes did not allow the taxpayer to average the recovery over future years of

practical matter, the taxpayer might not have funds available to pay the tax when it became due in the future years.

A more feasible solution would require that the taxpayer initially compute and pay his tax in the year of recovery in accord with the current averaging provisions. After a fixed period, *e.g.*, five years,<sup>129</sup> the taxpayer would file a second return on which he would recompute his tax on the recovery for lost earnings by averaging the amount of the recovery equally over either a new averaging period of ten years or the period during which the injury actually reduced his earnings, whichever period was shorter. In the example under discussion, the taxpayer would file the second return in 1983 and would average out the recovery over the period of actual injury (1976-1980), since that period is shorter than the ten-year averaging period (1973-1982). If the recomputation resulted in a lower tax liability<sup>130</sup> than incurred in 1977 because of the inclusion (with averaging) of the recovery in that year, the taxpayer would receive a refund. A liberalized averaging provision for damages of this type would counter one of the few possible arguments against taxing damages for loss of earnings caused by personal injury. It would also provide needed relief to the taxpayer who recovers for a business injury and finds himself with considerably less after-tax income because of progression than he would have had without the injury.

## V

### SOLICITUDE FOR THE TORTFEASOR

It is ironic that the tax exemption for lost earnings recoveries in personal injury cases has been explained in terms of protecting

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reduced earnings. *See* Act of Aug. 11, 1955, ch. 804, § 1(a), 69 Stat. 688 (now I.R.C. § 1304); Act of Aug. 26, 1957, Pub. L. No. 85-165, § 1, 71 Stat. 413 (now I.R.C. § 1305); Act of Sept. 2, 1958, Pub. L. No. 85-866, § 58(a), 72 Stat. 1646 (originally enacted as I.R.C. § 1306) (repealed 1964).

<sup>129</sup> This is a purely arbitrary period, admittedly subject to serious criticism. If, for example, an individual is 20 years old when injured and the damage award is meant to compensate for loss of earnings over his lifetime, averaging the award over 10 years, rather than five, is still not much help. A line must be drawn, however, and 10 years is preferable to five. But if the Service would extend the period further, or reopen the return twice, *e.g.*, after five years and again after 15, the result would be even better.

<sup>130</sup> Averaging the recovery over the period of actual injury may result in a higher tax liability. In the example under discussion, if the taxpayer's income increases significantly from 1978 through 1980, the second averaging may produce a higher liability. Arguably, the Service is entitled to the increase, but because it has had the use of the taxpayer's tax payment for five years, its claim to more revenue is less compelling. There are limitations to the requirement of mathematical precision.

tortfeasors from unfairly high judgments.<sup>131</sup> Consider the following hypothetical situation. Suppose damages for lost earnings were fully taxable in the year of receipt. Suppose also that a victim, anticipating average earnings of \$100,000 per annum over the ten remaining years of his life expectancy, sues a tortfeasor who negligently caused an injury resulting in permanent loss of earning capacity. Without the injury, the total value of the lost earnings would have been \$1,000,000, on which the victim would have incurred tax liability of \$451,800,<sup>132</sup> leaving a net after-tax income of approximately \$550,000. Suppose that the jury is aware that the injured party's recovery is now fully taxable in the year of receipt.<sup>133</sup> A clever member of the jury takes out his slide rule and, to the astonishment of his fellow jurors, proves that the victim must be given approximately \$1,730,000 to receive an after-tax recovery of \$550,000.<sup>134</sup> He convinces his fellow jurors to make the victim whole<sup>135</sup> by awarding a judgment

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<sup>131</sup> See B. BITTKER & L. STONE, *FEDERAL INCOME ESTATE AND GIFT TAXATION* 95-96 (1972).

<sup>132</sup> I.R.C. § 1(a) (a yearly tax of \$45,180 on taxable income of \$100,000). This assumes, again, that the victim's entire gross income would be taxable income and that he would have no income other than his earnings. See note 109 *supra*. The analysis would be essentially the same even if these assumptions were changed.

<sup>133</sup> Whether a jury should be instructed that personal injury awards are not taxable under present law has been much debated. Compare Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 231-38 (1958) and Comment, *Personal Injury Awards and the Nonexistent Income Tax—What is a Proper Jury Charge?*, 26 FORDHAM L. REV. 98 (1957) (both supporting such instruction) with 33 B.U.L. Rev. 114, 116 (1953) (opposing such instruction). Cases in the United States have gone both ways. Compare Dempsey v. Thompson, 363 Mo. 339, 346, 251 S.W.2d 42, 45 (1952) (instruction required) with Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955) (instruction refused).

The British approach the problem differently. If a recovery is nontaxable, the amount of the award is reduced by the amount of taxes that the plaintiff would have been required to pay on the lost earnings. British Transp. Comm'n v. Gourley, [1956] A.C. 185. This rule, which gives the defendant the benefit of the tax exemption, has been severely criticized. Dworkin, *supra* note 84, at 322-30; Jolowicz, *Damages and Income Tax*, 1959 CAMBRIDGE L.J. 86.

The question of a proper jury charge on the tax exemption is not within the scope of this Article, especially because I have concluded that damages in compensation for loss of earnings should be taxed. In the hypothetical under discussion, it is assumed that the jury will regard damages for loss of earnings as taxable like any other form of income. This is a reasonable assumption since some authorities believe that juries, despite the current exemption, assume that damages are taxable. See, e.g., Morris & Nordstrom, *Personal Injury Recoveries and the Federal Income Tax Law*, 46 A.B.A.J. 274 (1960); Comment, *Income Tax Effects on Personal Injury Recoveries*, 30 LA. L. REV. 672, 688 (1970).

<sup>134</sup> I.R.C. § 1(a) (tax on \$1,730,000 of approximately \$1,182,000, leaving after-tax income of \$548,000). This assumes the victim is married and files a joint return. See *id.* § 143.

<sup>135</sup> Compensating the injured party for his loss is the primary purpose of tort damages. 2 F. HARPER & F. JAMES, *THE LAW OF TORTS* § 25.1 (1956); W. PROSSER, *HANDBOOK*

of \$1,730,000.<sup>136</sup>

Because of the progressive tax structure, the injured party needs a considerably higher pre-tax recovery to equal the after-tax income he would have earned had he not been disabled. Thus, the tortfeasor is, in effect, giving the government a tax windfall,<sup>137</sup> unless he is able to take a deduction for the judgment<sup>138</sup> and has income against which to apply the deduction.<sup>139</sup> It would be unfair to require a tortfeasor to pay a judgment embracing not only the victim's usual taxes on his lost earnings, but also a vastly higher tax liability resulting from progressive tax rates on a recovery representing income lost over a period of years. If liberalized averaging provisions were enacted to mitigate the inequitable effects of progression,<sup>140</sup> both the victim's tax liability and the tortfeasor's consequent damage liability would be reduced in the hypothetical under discussion.<sup>141</sup> The tortfeasor would be required to make both the injured party and the government whole, and usually not much more.<sup>142</sup> Under liberalized averaging, therefore, solicitude

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OF THE LAW OF TORTS § 2, at 7 (4th ed. 1971). Thus, the mathematically inclined juror is on firm ground in wanting to make the victim whole. See text accompanying notes 216-17 *infra*.

<sup>136</sup> For the purpose of analysis, the possible advantage or disadvantage of receiving the recovery at the time of the settlement or judgment, rather than when the victim would have made his earnings, is ignored.

<sup>137</sup> In the example under discussion, the windfall may be as high as \$730,000—i.e., the difference between the tax that the victim would pay on his recovery (\$1,182,000) and the amount of taxes he would have paid on his earnings (\$451,800). See notes 132 & 134 *supra*.

<sup>138</sup> The tortfeasor would be able to take a deduction if, for example, the payment of the judgment or settlement were an "ordinary and necessary" business expense. I.R.C. § 162(a). If the tortfeasor is insured, the insurance company would, of course, be able to deduct its payment of the judgment as a business expense. In this case, the government would not receive a tax windfall, except possibly to the extent that the insurance company's marginal tax rate is less than that of the victim.

<sup>139</sup> To the extent that the tortfeasor's income does not equal the amount of the deduction, the government gets a tax windfall because the victim is taxed fully on the recovery. However, the tortfeasor does not get the full tax benefit from the deduction unless he can use the excess of the deduction over his income as a net operating loss carryback or carryforward to another taxable year. See I.R.C. § 172.

<sup>140</sup> See notes 108-30 and accompanying text *supra*.

<sup>141</sup> Under the liberalized averaging proposal, the victim would eventually be able to spread out the recovery over 10 taxable years. See notes 129-30 and accompanying text *supra*. To make the injured party whole, the jury would have to assure him an income after averaging over 10 years of \$550,000 (\$55,000 a year). See note 132 and accompanying text *supra*. Assuming that he continues to be taxed on the joint return basis, his yearly taxable income would have to be \$100,000 to produce an after-tax income of approximately \$55,000. See I.R.C. § 1(a). Thus, the jury would have to award \$1,000,000 to give him the same after-tax income as he would have had—considerably less than the award necessary to make him whole without liberalized averaging. See notes 134-36 and accompanying text *supra*.

<sup>142</sup> Even under my suggested revision of the averaging provisions for damages, it is

for the tortfeasor would not provide a persuasive justification for exempting lost earning recoveries from taxation.

## VI

### ANTITRUST DAMAGES

In a private suit under the Sherman<sup>143</sup> or Clayton Acts,<sup>144</sup> a victim of an antitrust violation may recover profits lost because of the injury. In addition, the injured party may receive treble damages as a penalty for the wrongful conduct.<sup>145</sup> The taxation of these elements of a recovery presents some interesting tax policy issues.

#### A. *Punitive Damages*

Under *Glenshaw Glass*, punitive damages in an antitrust action are taxable in full as ordinary income.<sup>146</sup> This rule has been criticized by one commentator<sup>147</sup> who has argued that punitive damages should receive favorable tax treatment to ensure that the policy behind the treble damage provisions—namely, to encourage private suits against antitrust violators<sup>148</sup>—will not be thwarted by a tax disincentive.<sup>149</sup> The existence of valid policy reasons for granting favorable tax treatment to punitive damages in antitrust actions does not mean that *Glenshaw Glass* was wrongly decided—it is Congress' responsibility, not the Court's, to make such policy determinations. Congress was responsible for enacting the treble damage

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possible that the victim's tax liability on the recovery will be greater than it would have been had the injury not occurred. See text accompanying notes 129-30 *supra*. If the victim does have a greater tax liability and if the award compensates for this increased liability, the wrongdoer is making the government somewhat more than "whole."

<sup>143</sup> 15 U.S.C. §§ 1-7 (1970 & Supp. V 1975).

<sup>144</sup> *Id.* §§ 12-27.

<sup>145</sup> *Id.* § 15 (1970).

<sup>146</sup> 348 U.S. at 431.

<sup>147</sup> Wright, *supra* note 4, at 247-49. Wright argues that despite the recovery of treble damages, it was too expensive to bring many private actions even before *Glenshaw Glass*. Among the major problems facing plaintiffs are the difficulty of proving the full amount of damages, the time and trouble of bringing suits, and the failure to fully recover in a court award the legal expenses of bringing suit. *Id.* at 249-50.

<sup>148</sup> *Lawlor v. National Screen Serv. Corp.*, 349 U.S. 322, 329 (1955); S. REP. NO. 619, 84th Cong., 1st Sess. 3 (1955), reprinted in [1955] U.S. CODE CONG. & AD. NEWS 2328, 2330; REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTI-TRUST LAWS 378 (1955).

<sup>149</sup> Wright, *supra* note 4, at 256-57.

incentive, and it is best able to determine how great the incentive should be—i.e., whether punitive damages should be fully taxable, fully exempt, or taxable at some favorable rate.<sup>150</sup> In making that determination, one consideration might be that an increase in the number of private actions could diminish the need for government intervention against antitrust violators. Thus, Congress could weigh the revenue loss resulting from a tax break for punitive damages against possible savings in government antitrust enforcement costs.<sup>151</sup> More broadly, Congress would have to determine whether the gains from increased competition, possibly resulting from a greater threat of private suits, are worth the net budget cost of favorable tax treatment.<sup>152</sup>

There are, however, a number of serious objections to singling out punitive antitrust damages for special treatment. Since punitive damages are disposable income subject to the recipient's control—just as profits or salary income<sup>153</sup>—the policy justifications should be convincing before Congress grants favorable tax treatment. In addition, the proponents of a statutory revision of *Glenshaw Glass* must counter the argument that windfalls such as punitive damages should be taxed at least as heavily as other forms of in-

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<sup>150</sup> Wright made two suggestions for favorable treatment: either tax only two-thirds of a treble damage antitrust recovery, or tax punitive damages as if they were long-term capital gains. Wright, *supra* note 4, at 256. The effect of the first proposal is to tax fully the one-third of a recovery that represents compensation for lost profits and to tax the two-thirds that represent punitive damages at one-half of the usual rates on ordinary income. For individuals, the net result of this proposal on the taxation of punitive damages would be similar to the effect of the 50% deduction for capital gains. See I.R.C. § 1202. For corporations normally taxed at a 48% rate, the net result would be a tax rate of 24% on punitive damages. See I.R.C. § 11(b)(2), (c)(3).

The second suggestion is easier to analyze. In the case of corporations, punitive damages would be taxed at a maximum rate of 30%—the tax rate for corporations on capital gains. I.R.C. § 1201(a). In the case of individuals, punitive damages either would be taxed at the optional 25% rate on capital gains up to \$50,000 (I.R.C. § 1201(b), (d)), or would be deductible to the extent of one-half the net capital gain (I.R.C. § 1202). For both corporations and individuals, punitive damages would be subject to the minimum tax on tax preference items. I.R.C. § 57(a)(9).

<sup>151</sup> For the argument that an increase in the number of private suits may reduce government enforcement costs, see *Study of Monopoly Power—Hearings Before the Subcommittee on Study of Monopoly Power of the House Committee on the Judiciary on H.R. 3408*, ser. 1, pt. 3, 82d Cong., 1st Sess. 15 (1951) (statement of H. Graham Morison, Assistant Attorney General in charge of the Antitrust Division, United States Department of Justice).

<sup>152</sup> For a general discussion of the use of a tax expenditure rather than a direct expenditure to achieve a non-tax policy goal, see Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX. J. 244 (1969); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

<sup>153</sup> See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).



come, since it is less likely that taxing windfalls will reduce socially productive economic incentives.<sup>154</sup> Finally, Congress should hesitate before extending favored treatment to one class of litigants, when other classes may have an equal claim to special tax status.<sup>155</sup>

### B. *Compensatory Damages*

Damages received in an antitrust action as compensation for lost profits are taxable as ordinary income. Section 186 of the Code, however, added by the 1969 Tax Reform Act,<sup>156</sup> applies a tax-benefit principle<sup>157</sup> to reduce or eliminate the tax on such a recovery under certain circumstances. Under section 186 a taxpayer is allowed to deduct an amount equal to the compensatory damage amount,<sup>158</sup> if during the years affected by the antitrust violation the taxpayer had net operating losses in an amount greater than or equal to the amount of the compensatory damages, and if these net operating losses were not absorbed in carryovers or carrybacks.<sup>159</sup> If the amount of such net operating losses is less than the recovery, the lesser amount may be deducted.<sup>160</sup>

A simplified example may help explain the operation of section 186. An antitrust violation occurs during the years 1970-1974,

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<sup>154</sup> Windfalls, by definition, are not acquired by any effort on the part of the recipient. See Comment, *supra* note 103, at 748. Thus, taxation of windfalls should not interfere with economic incentive.

<sup>155</sup> Based on some of Wright's arguments (*see* note 147 *supra*), one might conclude that all awards of punitive damages should be nontaxable. Punitive damages are awarded partly to deter wrongdoing. If punitive damage recoveries were exempt, the incentive to sue would be enhanced, thereby increasing the possibility of deterring potential wrongdoers. It is doubtful, however, whether the actual deterrent effect is so beneficial, or the budgetary cost so small, that recipients of punitive damage awards, unlike other taxpayers, should be allowed to enjoy an increase in their disposable income with no tax liability to the government. See text accompanying notes 230-32 *infra*.

<sup>156</sup> Pub. L. No. 91-172, § 904(a), 83 Stat. 711 (1969) (codified at I.R.C. § 186).

<sup>157</sup> The term "tax benefit" usually refers to the doctrine that the return of an amount deducted in a previous year will be included in income only if the previous deduction gave rise to a "tax benefit." See note 75 *supra*. Nonetheless, the operation of § 186 is sufficiently similar to warrant the use of the term "tax benefit." The Senate Report on the 1969 Tax Reform Act described the operation of the provision in terms of a tax benefit: "[A] special deduction is to be allowed which has the effect of reducing the amounts required to be included in income to the extent that the losses to which they relate did not give rise to a tax benefit." S. REP. NO. 552, 91st Cong., 1st Sess. 278, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2316. The Conference Report adopted the same language. CONF. REP. NO. 782, 91st Cong., 1st Sess. 332, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2392, 2448.

<sup>158</sup> I.R.C. § 186(a)(1).

<sup>159</sup> *Id.* § 186(d)(1), (2).

<sup>160</sup> *Id.* § 186(a)(2).

costing the taxpayer \$50,000 in yearly income. Assume that the taxpayer had net operating losses of \$40,000 each year from 1970 through 1974. In 1980 the taxpayer recovers a \$250,000 judgment to compensate for the lost profits. This judgment would be includable in the taxpayer's 1980 income. Assuming that the net operating losses were not absorbed as carrybacks or carryovers in other taxable years,<sup>161</sup> the taxpayer may deduct \$200,000 from his income—*i.e.*, the amount of the earlier net operating losses—thereby reducing his taxable income from the compensatory damage award to \$50,000.<sup>162</sup>

Although the operation of section 186 is somewhat complicated, its purpose is simple. Compensatory damages should be taxable when the lost profits for which they compensate would also have been taxable. To the extent that the profits would have been offset by net operating losses, the compensatory damages should also be offset. Section 186 accomplishes this result.

In addition to antitrust recoveries, the section applies to damages received for infringement of a United States patent<sup>163</sup> and to damages received for breach of contract or breach of a fiduciary duty.<sup>164</sup> It is hard to see why Congress has limited the provision to these types of damages. As a general rule, it would seem that damages for lost profits should be exempt from taxation *whenever* the profits for which the damages are meant to compensate would not have been taxed because of net operating losses in the year or years of the injury.<sup>165</sup>

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<sup>161</sup> Generally, a taxpayer may carry back a net operating loss to each of the three taxable years preceding the taxable year of the loss and may carry forward a net operating loss to each of the seven taxable years following the taxable year of the loss. I.R.C. § 172(b)(1)(A)(i), (b)(1)(B).

<sup>162</sup> *Id.* § 186(a)(2).

<sup>163</sup> *Id.* § 186(b)(1).

<sup>164</sup> *Id.* § 186(b)(2).

<sup>165</sup> Currently, § 186 operates only retroactively—*i.e.*, the taxpayer gets a deduction only if there were unused net operating losses in years prior to the year in which he receives the damage award. *Id.* § 186(d)(2) ("injury period" defined in past tense). Theoretically, if there are net operating losses in future years, and if the damage award compensates for loss of earnings in those years, the deduction should be available. This is another area in which simplicity of administration, particularly the annual accounting principle, may prevail over sound tax policy. *See* notes 14 & 127 and accompanying text *supra*. A possible compromise between sound theory and simplicity of administration would allow a taxpayer, who has received an award compensating for loss of future earnings, to readjust his income after some fixed period in accordance with the principles of § 186. Such a procedure would resemble the liberalized averaging proposal suggested earlier in this Article. *See* notes 129-30 and accompanying text *supra*.

## VII

TAXATION AND THE PURPOSES OF DAMAGES  
AWARDED FOR BREACH OF CONTRACT

Although it is sometimes broadly stated that damages for breach of contract are income,<sup>166</sup> the following examples will show that this general rule should be subject to exception.

A. *Reliance Damages*

Under certain circumstances, the victim of a breach of contract may recover from the breaching party the expenses incurred in reliance on the contract.<sup>167</sup> Such damages are taxable, whether they represent damages in compensation for essential reliance expenses or for incidental reliance expenses.<sup>168</sup> The taxation of such damages rests on the assumption that the reliance expenses were incurred and deducted in prior years.<sup>169</sup> If this assumption is correct, the damages are properly taxable.<sup>170</sup> If, however, the expenses were not deductible,<sup>171</sup> the damages ought not be taxable,<sup>172</sup> since a tax would in effect be a tax on the injured party's capital.<sup>173</sup>

Assuming the expenses were properly deductible, the recovery is apparently taxable<sup>174</sup> even when the taxpayer received no tax benefit from the deduction, because of net losses in the earlier years.<sup>175</sup> This result is proper under current law because section 186 of the Code will enable the injured party to deduct net operating losses incurred in the year affected by the breach of contract from any damage recovery on the breach, even when the net operating losses could not otherwise be carried forward to the year of recovery.<sup>176</sup>

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<sup>166</sup> See Plumb, *supra* note 3, at 222.

<sup>167</sup> The leading article analyzing the award of reliance damages is Fuller & Perdue, *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52 (1936).

<sup>168</sup> See Plumb, *supra* note 3, at 222-23.

<sup>169</sup> *Id.*

<sup>170</sup> See note 75 and accompanying text *supra*.

<sup>171</sup> See, e.g., I.R.C. §§ 262-263.

<sup>172</sup> If the expenses are capital expenditures that increase the taxpayer's basis in an asset, the damages, when received, ought to reduce the taxpayer's basis in the asset.

<sup>173</sup> See text accompanying notes 58-63 *supra*.

<sup>174</sup> See Plumb, *supra* note 3, at 223 n.14.

<sup>175</sup> *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

<sup>176</sup> See notes 156-62, 164 and accompanying text *supra*. One minor problem with the operation of § 186 in this context is that the taxpayer gets the benefit only of net operating losses within the "injury period," which is defined as "the period during which amounts would have been received or accrued but for the breach of contract." I.R.C. § 186(d)(2)(B). Thus, if the expenses were incurred in a year before amounts were due under the contract,

### B. *Restitution Damages*

In certain cases when one party breaches a contract, the injured party may recover restitution damages—*i.e.*, the benefits conferred on the breaching party by the injured party's performance under the contract.<sup>177</sup> If the expenses and costs incurred by the plaintiff in performing the contract were deductible, the full amount of restitution damages ought to be taxed to him. Since restitution damages are intended to force the defendant to disgorge the benefits received under the contract,<sup>178</sup> such damages are, in a tax sense, similar to a windfall<sup>179</sup> to the plaintiff and, like windfalls generally, should be taxable.<sup>180</sup> Since section 186 is applicable to damages for breach of contract, the plaintiff should be taxed on the entire recovery (provided that his expenses were deductible), even if the deduction for the expenses produced no tax benefit originally because of net operating losses in the years affected by the injury.<sup>181</sup> If the expenses incurred in performing the contract were not deductible, the restitution damages ought to be taxable only to the extent that they exceed the plaintiff's non-deductible expenses.<sup>182</sup> This result will assure that no tax is imposed on the injured party's capital.<sup>183</sup>

### C. *Expectation Damages*

The basic principle of expectation damage awards is to put the nonbreaching party in the position he would have been in had the contract been performed.<sup>184</sup> The following examples illustrate how appropriate rules for taxing such damages can ensure that the injured party receives the benefit of his bargain.

#### 1. *Employment Contracts*

If an employer breaches an agreement to employ or to pay a certain wage to an employee, the employee can generally recover

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§ 186 might not help the taxpayer if he did not have net operating losses in the injury period.

<sup>177</sup> See D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 12.1, at 791-95 (1973), for a general discussion on the recovery of restitution damages.

<sup>178</sup> *Id.* at 791-92.

<sup>179</sup> The contract price may in some cases set an upper limit on the recovery and, therefore, on the amount of the windfall. See Palmer, *The Contract Price as a Limit on Restitution for Defendant's Breach*, 20 OHIO ST. L.J. 264 (1959).

<sup>180</sup> See text accompanying notes 9 & 106-07 *supra*.

<sup>181</sup> See text accompanying notes 156-65 *supra*.

<sup>182</sup> But if the expenses increase the taxpayer's basis in an asset, his basis ought to be reduced to the extent of the damages. See note 172 *supra*.

<sup>183</sup> See text accompanying notes 52-54, 58-63 & 173 *supra*.

<sup>184</sup> See 5 A. CORBIN, *CONTRACTS* § 1002 (1964).

the difference between the contract price for his services and the amount he earns in a new job, or, alternatively, the amount the employer can prove the employee could earn by reasonable effort in a new job.<sup>185</sup> These damages are properly taxable to the employee, since his salary would have been taxable if the employer had not breached the contract. Taxing the damages is therefore consistent with giving the nonbreaching employee the benefit of his bargain with the employer.<sup>186</sup>

If the employee breaches the contract, the employer can recover expectation damages measured by any additional cost incurred in obtaining substitute services.<sup>187</sup> Since this additional cost is deductible by the employer,<sup>188</sup> it is proper to tax damages received in compensation for such deductible expenses. The net effect of including the damages in gross income and allowing a deduction for the increased costs is a tax wash that will put the employer in exactly the same position he would have been in had the contract been performed.<sup>189</sup>

## 2. Construction Contracts

If a contractor breaches a construction contract, the injured party will usually recover either the cost of finishing construction in accordance with the contract, or the difference between the value of the improvement bargained for under the contract and the value of the improvement actually received from the contractor's performance.<sup>190</sup> If the injured party's recovery equals the amount necessary to complete the project, and he uses the recovery to complete construction (or has already incurred the costs in completing construction), the most sensible tax result would be to reduce his basis in the completed building by the amount of the damages. This reduction in basis will place the injured party in exactly the same position he would have been in had the contract been performed.<sup>191</sup> If the injured party receives damages meas-

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<sup>185</sup> See D. DOBBS, *supra* note 177, § 12.25, at 924-25.

<sup>186</sup> In addition, more liberalized averaging provisions would ensure that the wronged employee is not taxed more heavily because of income-bunching than he would have been had the contract been performed. See text accompanying notes 108-30 *supra* and notes 227-28 *infra*.

<sup>187</sup> See D. DOBBS, *supra* note 177, § 12.26, at 932.

<sup>188</sup> I.R.C. § 162(a)(1).

<sup>189</sup> This assumes that the employer has also been awarded interest to compensate for the loss of the use of his money during the period between the date of the payment of additional compensation and the date of the recovery. Such interest will be taxable (see note 13 *supra*), as would the income his money would have earned but for the injury.

<sup>190</sup> See D. DOBBS, *supra* note 177, § 12.21.

<sup>191</sup> To take a simple example, assume the injured party pays \$10,000 for the building

ured by the cost of completion, but chooses not to complete the project, it is less appropriate to insist that the tax consequences reflect the "benefit of the bargain" principle because the injured party has effectively opted against fulfilling the bargain. In receiving damages measured by the cost of completion, without actually incurring those costs, the injured party has recovered an amount resembling a windfall which should properly be taxable in full as ordinary income.<sup>192</sup>

The same principles apply when the injured party receives damages measured by the "difference in value" formula. Assume that he bargained for a building worth \$100,000, but received a building worth \$75,000, and that his recovery is therefore \$25,000. Let us assume that the contract required the injured party to pay \$100,000 for the building. Given these facts, the proper tax result would be to reduce his cost basis (\$100,000) in the building by the amount of damages received (\$25,000), thereby arriving at an adjusted basis of \$75,000. If the injured party subsequently sells the building for its value of \$75,000, he will have no taxable gain, a result accurately reflecting his tax situation. Since the amount of the damages is offset by the decrease in the worth of the building, the taxpayer has had no real economic gain.<sup>193</sup>

Let us change the hypothetical so that the contract price is \$80,000—*i.e.*, the injured party originally receives the better of the bargain in the sense that he is paying \$80,000 for a building worth \$100,000 upon completion. If he receives \$25,000 in damages based on the difference in value formula, it is interesting to specu-

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under the contract and incurs additional costs of \$2,000 in completing the building. These additional costs would increase his basis to \$12,000. If he recovers damages of \$2,000, his basis would be reduced to \$10,000—his basis in the building had the contract been properly performed.

<sup>192</sup> See text accompanying notes 9 & 106-07 *supra*. The same rule should apply to any excess of the injured party's recovery over his actual cost of completion. Thus in the example in note 191 *supra*, if the injured party's additional costs are only \$1,000, his basis will be reduced by \$1,000, and the remaining \$1,000 of damages will be includable in his gross income.

<sup>193</sup> One alternative tax scenario might include the \$25,000 recovery in the taxpayer's income, while allowing him to retain a basis of \$100,000 in the building. Upon a subsequent sale of the building for its \$75,000 value, the taxpayer would show a loss of \$25,000. This alternative, quite unfavorable to the taxpayer, would deprive him of the benefit of the bargain for three reasons. First, it would result in the addition of \$25,000 to his income when he would have had no immediate income had the contract been performed. Second, the damages would be ordinary income since there would be no sale or exchange (see note 70 and accompanying text *supra*), but the loss upon a subsequent sale would be treated as a capital loss, less easily deductible than an ordinary loss. I.R.C. § 1211. Third, if the building were used by the taxpayer for personal purposes, his loss on a subsequent sale would not be deductible at all. I.R.C. § 165(c).

late on the taxation of the damages. It is arguable that the injured party has realized a taxable gain of \$20,000 measured by the difference between the value of the building acquired (\$75,000) plus the damages (\$25,000), and his cost in the building (\$80,000). Yet the gain results not from the breach, but from the bargain itself. Thus the taxpayer has a strong argument against immediate taxation of this gain, since the gain would not have been taxed immediately if the contract had been performed and the taxpayer had obtained a \$100,000 building for \$80,000. In addition, if the gain were taxed immediately it would probably be taxed as ordinary income rather than capital gain because there has been no sale or exchange.<sup>194</sup> But if the contract had been fully performed and the taxpayer had received a building worth \$100,000 for \$80,000, his gain on a subsequent sale would usually be taxed under the more favorable rules for capital gains.<sup>195</sup>

To give the injured party the full benefit of his bargain, therefore, it seems proper to reduce his cost basis of \$80,000 by the amount of the damages (\$25,000), producing an adjusted basis of \$55,000.<sup>196</sup> Upon a subsequent sale of the building for its value (\$75,000), the injured party would have a gain of \$20,000, presumably taxable at capital gains rates. Reducing the basis, rather than taxing the damages immediately, would therefore place the injured party in approximately<sup>197</sup> the same position as he would have been in had the contract been performed.

### 3. *Contracts to Purchase or Sell Land*

If a seller breaches a contract to sell land, the buyer may seek remedies such as specific performance, or expectation damages measured by the difference between the market value of the land

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<sup>194</sup> See notes 64-71 and accompanying text *supra*.

<sup>195</sup> See I.R.C. §§ 1201, 1202, 1221, 1231.

<sup>196</sup> An interesting case that adopted the reduction-of-basis technique was *Henri Chouteau*, 22 B.T.A. 850 (1931), in which the taxpayer-buyer successfully reduced his basis in the purchased stock by an amount equal to a damage recovery representing the difference in value between the stock as promised and the stock as received. The court rejected the Commissioner's argument that the damages were includable immediately in the taxpayer's gross income.

<sup>197</sup> Arguably, under this approach the injured party would be in a somewhat better position by having the immediate use of the \$20,000 in damages, and he would not be taxed until he actually realized a gain by selling the property for \$75,000. On the other hand, had the contract been performed, the taxpayer would have had the use of property worth \$20,000 more than the property actually received. In any case, the alternative of taxing the damages immediately as ordinary income puts the injured party in a significantly worse position than he would have been in had the contract been performed.

and the contract price.<sup>198</sup> If the buyer gets specific performance, no immediate tax consequences should follow—the buyer simply takes as his basis in the land the purchase price<sup>199</sup> and computes his gain or loss upon subsequent sale accordingly.

If the buyer succeeds in recovering expectation damages, the proper tax consequences are less obvious. Assume the contract price was \$100,000 and the land was worth \$120,000, giving the buyer damages of \$20,000. If the buyer has not acquired substitute property by the time of the recovery, the damages ought to be taxed as ordinary income because in the absence of a substitute purchase the damages resemble a windfall.<sup>200</sup> But if the buyer has acquired replacement property for \$120,000, his claim to a reduction in the basis of the property acquired by the amount of the damages is strong. Reducing the basis would mean that the damages would not be taxed immediately as ordinary income, but would be taxed upon a subsequent sale of the property for its value,<sup>201</sup> presumably as a capital gain.<sup>202</sup> These tax results give the buyer the full benefit of his bargain since he would not have been taxed immediately on his profit from the bargain had the land been conveyed in accordance with the contract.<sup>203</sup>

When the buyer breaches his contract to purchase land, the seller can generally recover expectation damages measured by the difference between the contract price and the market value of the land.<sup>204</sup> One case holds that such damages are taxable immediately as ordinary income,<sup>205</sup> but at least three other tax results are possible. First, the damages may be taxable as a capital gain<sup>206</sup> (assuming the land is a capital asset); second, the damages may reduce the seller's basis in the property;<sup>207</sup> or, third, the damages may be

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<sup>198</sup> See D. DOBBS, *supra* note 177, § 12.7. In certain cases consequential damages may also be recovered. *Id.* § 12.8, at 841-42.

<sup>199</sup> I.R.C. § 1012.

<sup>200</sup> See text accompanying notes 9 & 106-07 *supra*.

<sup>201</sup> The taxpayer's basis would be \$100,000, his amount realized \$120,000, and his gain \$20,000. See I.R.C. § 1001(a), (b).

<sup>202</sup> *Id.* §§ 1201, 1202, 1221, 1231.

<sup>203</sup> He would be taxed only when and if he "realized" the profit. *Eisner v. Macomber*, 252 U.S. 189 (1920).

<sup>204</sup> See D. DOBBS, *supra* note 177, § 12.7. In certain cases, consequential damages may also be recovered. *Id.* § 12.11.

<sup>205</sup> See Gerald Melone, 45 T.C. 501, 507-08 (1966).

<sup>206</sup> Cf. Alvin B. Lowe, 44 T.C. 363, 374-75 (1965) (damages held taxable as capital gain).

<sup>207</sup> In the *Lowe* case the court rejected the taxpayer's argument that his basis in the property should have been reduced by an amount equal to the damage recovery. *Id.* at 372-73.



added to the amount realized when the seller sells the property. For various reasons the last alternative seems to be the proper tax result.

Taxing the damages as a capital gain is improper because the taxpayer-seller has not engaged in a capital asset transaction.<sup>208</sup> Although this Article has previously criticized the rule that requires a sale or exchange for capital asset treatment,<sup>209</sup> a minimum requirement for capital gain treatment should be that the taxpayer part with the capital asset either voluntarily (by a sale or exchange) or involuntarily (through conversion or destruction).

Reducing the seller's basis in the property is equally unsound. Unlike the owner in the construction contract example, or the buyer who recovers damages from a breaching seller,<sup>210</sup> the seller has not actually reduced his cost in the property by recovering expectation damages from the buyer. In those earlier examples the owner and the buyer may justifiably reduce their bases by the amount of the damages because the other party's breach increased their costs beyond the price set by the contract. Such reasoning does not apply to a seller who recovers damages from a breaching buyer.

The most sensible tax result has the seller treat the damages as part of the amount realized upon a subsequent sale of the property. Assume that the contract price was \$120,000, the fair market value of the property was \$100,000, and the seller's basis was \$90,000. Assume also that upon the buyer's breach the seller sells the property to another purchaser for \$100,000, producing a gain of \$10,000 which is presumably taxable as a capital gain.<sup>211</sup> When the seller recovers expectation damages of \$20,000, the damages would be treated as an increase in the amount realized and taxed as an additional capital gain of \$20,000.<sup>212</sup> Including the damages in the amount realized generally puts the seller in the same position he would have been in had the contract been performed. If the buyer had performed, the seller would have realized the pur-

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<sup>208</sup> See Gerald Melone, 45 T.C. 501, 507-08 (1966); Ralph A. Boatman, 32 T.C. 1188, 1191-92 (1959). But see Alvin B. Lowe, 44 T.C. 363, 373-75 (1965).

<sup>209</sup> See notes 72-73 and accompanying text *supra*.

<sup>210</sup> See notes 190-92, 200-03 and accompanying text *supra*.

<sup>211</sup> This gain will be taxed as a capital gain if the asset is a capital asset. I.R.C. §§ 1202, 1221, 1222.

<sup>212</sup> Absent a "sale or exchange" at the time of the recovery, the recovery may be taxable as ordinary income. See text accompanying notes 70-71 *supra*. But when the damages are added to the amount realized, they ought to be taxed in the same way as the original transaction to which they relate, *i.e.*, as a capital gain. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

chase price of \$120,000, producing a capital gain of \$30,000.<sup>213</sup> Treating the damages as part of the amount realized ultimately results in an equal amount of capital gain.<sup>214</sup> One difference, of course, is that the seller is not taxed on the full amount of the gain until he recovers the damages, but this difference is unavoidable since it is impossible to determine the amount of the gain, or indeed, whether there is a gain, until the seller recovers his damages.

In the above examples it has been assumed that the seller sold the property to another buyer after the breach. But if the seller does not sell the property, it is less appropriate to apply the "benefit of the bargain" principle for tax purposes, because the seller has in effect opted against fulfilling his part of the contract. Where the seller has not disposed of the land by the year of the recovery, the damages resemble a windfall and should be taxed as ordinary income.<sup>215</sup>

## VIII

### TAXATION AND THE PURPOSES OF TORT RECOVERIES

The rules proposed above for the taxation of damage recoveries are consistent with traditional tort-law principles. The primary purpose of most tort recoveries is compensation of the victim for losses caused by the tort.<sup>216</sup> If a victim is awarded compensatory damages exactly equal to the amount of his loss, then a tax on the recovery may result in undercompensation of the victim. Conversely, if the victim receives compensatory damages equal to the amount of his gross earnings lost because of the injury, and if no tax is levied on the recovery, then the victim may be overcompensated for his loss (since his gross earnings would have been taxed but for the injury).<sup>217</sup>

#### A. *Pain and Suffering*

When a judge or a jury sets damages for pain and suffering, it is an attempt to quantify an intangible loss which the victim incurred as a consequence of tortious conduct. Although some commentators question whether a monetary award can accurately re-

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<sup>213</sup> See I.R.C. § 1001.

<sup>214</sup> Ten thousand dollars is taxable immediately upon sale of the property and \$20,000 is taxable upon recovery of the damages.

<sup>215</sup> See text accompanying notes 9 & 106-07 *supra*.

<sup>216</sup> 2 F. HARPER & F. JAMES, *supra* note 135, § 25.1.

<sup>217</sup> See *id.* § 25.12 (argument that present exemption for lost earning recoveries in personal injury cases leads to overcompensation of victim).

flect such a loss,<sup>218</sup> compensating the victim is, at least theoretically, the purpose of the award.<sup>219</sup> If the jury awards an appropriate amount, a tax on the recovery will result in undercompensation of the victim. Hence a tax exemption for pain and suffering damages assures that the compensatory purpose of the award will be fully effectuated.

### B. *Loss of Capital and Expenses*

Capital is not taxed under the Internal Revenue Code.<sup>220</sup> If an award is intended to compensate a victim for loss of capital, taxation of the recovery will result in undercompensation, since the victim's capital would not have been taxed had he not suffered the loss. Damages in compensation for expenses incurred because of the injury should likewise be exempt, since such damages constitute a return of the victim's capital which would be intact but for the injury. In both cases, the exemption from tax reinforces the compensatory purpose of the damage award.

### C. *Loss of Earnings*

The usual rule is that damages for loss of earnings are computed on the basis of the gross income lost as a result of the injury.<sup>221</sup> Because of the current tax exemption for such damages, a plaintiff will almost always be overcompensated for lost earnings, since an award on the basis of gross income fails to account for the income tax that the plaintiff would have paid on such gross income.<sup>222</sup>

There are two solutions to this violation of the compensation principle. The current British rule reduces the award by the amount of tax that the victim would have paid on the lost earnings.<sup>223</sup> This approach is somewhat objectionable because it is often difficult to predict the taxes on a victim's gross earnings. Moreover, it is difficult to see any policy justification for giving the tortfeasor, as opposed to the victim, the benefit of the exemption.<sup>224</sup>

Another solution, suggested earlier,<sup>225</sup> is to tax the victim on

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<sup>218</sup> See, e.g., D. DOBBS, *supra* note 177, § 8.1, at 544-45.

<sup>219</sup> See 2 F. HARPER & F. JAMES, *supra* note 135, § 25.10. See also 4 RESTATEMENT OF TORTS § 912, comment b (1939).

<sup>220</sup> See notes 58-60 and accompanying text *supra*.

<sup>221</sup> See D. DOBBS, *supra* note 177, § 8.8, at 576.

<sup>222</sup> See note 6 *supra*.

<sup>223</sup> See note 133 *supra* for a discussion of the British approach.

<sup>224</sup> See Dworkin, *supra* note 84, at 322-26 for an excellent presentation of the arguments against the British rule.

<sup>225</sup> See notes 129-30 and accompanying text *supra*.

the amount of a recovery that compensates for loss of earnings. Taxing the earnings would solve the overcompensation problem. Furthermore, it would assure that the tortfeasor would fully compensate losses of both the victim and the government.<sup>226</sup>

#### D. *Averaging*

Under current law, income averaging is not fully effective in alleviating the problem of income-bunching caused by a large damage recovery in one taxable year.<sup>227</sup> To the extent that income-bunching results in a higher tax than the victim would have paid on profits lost because of an injury, the victim is not fully compensated for his loss. In order to more fully effectuate the purpose of compensatory tort awards, it will be necessary to liberalize the current averaging rules for damage recoveries.<sup>228</sup>

#### E. *Section 186 and Net Operating Losses*

Occasionally a victim will receive an award in compensation for lost profits which would not have been taxed (or would have been taxed at a lower rate) had the profits been received in the years actually affected by the injury. This discrepancy will occur whenever the victim has net operating losses in the year of the injury which cannot be carried forward to the year of recovery. Under these circumstances the victim's net recovery after taxes will be less than it would have been had the injury not taken place. Because of the vagaries of the tax law, therefore, the victim is not made completely whole. Since this result violates the compensation principle, section 186 of the Internal Revenue Code should be expanded in order to extend to more tort victims the tax advantages of net operating losses in years affected by the injury.<sup>229</sup>

#### F. *Punitive Damages*

Punitive damages are generally designed to effectuate public policy through civil action against wrongdoers.<sup>230</sup> Such damages are awarded apart from any compensatory damages and are not intended to make the victim whole. Rather, punitive damages are exemplary in nature; they are meant to penalize and deter wrong-

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<sup>226</sup> See notes 140-41 and accompanying text *supra*. One British commentator has argued that the British should adopt a gross earnings measure of damages and should tax damages representing loss of earnings. See Dworkin, *supra* note 84, at 327-28.

<sup>227</sup> See notes 117-25 and accompanying text *supra*.

<sup>228</sup> See notes 126-30 and accompanying text *supra*.

<sup>229</sup> See notes 156-65 and accompanying text *supra*.

<sup>230</sup> See D. DOBBS, *supra* note 177, § 3.9, at 205.

ful conduct. This policy is not affected by taxation of the damages. As long as the wrongdoer pays, the admonitory purpose of the award is served—the amount actually retained by the victim is irrelevant.

One contrary consideration rests on the premise that punitive damages provide an incentive to the victim to sue in cases where a suit by a private individual, rather than the government, may be desirable.<sup>231</sup> The theory that the victim will be insufficiently encouraged to bring a socially desirable private action if the award is taxed has already been discussed in the context of antitrust suits.<sup>232</sup> As in the case of antitrust damages, proponents of favorable tax treatment of punitive damages generally bear the burden of proving that special treatment will significantly increase the incentive of victims to sue. The current volume of litigation in which plaintiffs seek punitive damages suggests that no further incentive is necessary. Because taxing punitive damages offends no other purpose for making such an award, the Supreme Court's decision in *Glenshaw Glass* that such damages are taxable should not be changed by statute.

### CONCLUSION

This Article has reviewed the policies that should underlie a rational system for taxing damages. Most of the current tax rules are supported by principles of tax policy. The current exemption for lost earning recoveries in personal injury cases is difficult to defend, however, and ought to be repealed.

The present rules for taxing damages are otherwise generally consistent with the non-tax policies in the damage award area. To the extent that the tax rules are inconsistent with non-tax policies, changes can be made to harmonize the most important tax and non-tax policies. However, tax legislation should not be expected to reflect *all* the non-tax purposes of damage recoveries. The fact that taxation may impede a non-tax purpose—e.g., the incentive to bring suit which the award of punitive damages provides—does not of itself require that the tax rule be changed to effectuate the non-tax policy. In some cases it may be inevitable that tax and non-tax policies will conflict. In such cases, the proper tax rule should yield only when Congress is convinced of the overriding importance of the conflicting non-tax objective.

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<sup>231</sup> *Id.*

<sup>232</sup> See notes 146-55 and accompanying text *supra*.